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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

9 DEC 1986

MEMORANDUM FOR: Alan P. Larson
Deputy Assistant Secretary for National Energy and Resources Policy
Department of State

FROM: [redacted] 25X1
Director of Global Issues

SUBJECT: Saudi Oil Policy After Yamani [redacted] 25X1

In response to your request, attached is our assessment of current Saudi oil policy objectives and their implications for the oil market. We believe prices probably will fluctuate in the $10-14 per barrel range over the next several months rather than rise to the King's goal of $18 per barrel. There is a risk, however, that if prices erode Riyadh will increase production substantially in pursuit of higher revenues, causing another major price collapse. Over the medium term, perhaps after next year or so, we believe that increased oil demand and the slowdown of non-OPEC production will make $18 oil achievable at current OPEC production levels. [redacted] 25X1

[redacted] 25X1

Attachment:
Saudi Oil Policy After Yamani
GI M 86-20282, December 1986, [redacted] 25X1

[redacted] 25X1

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SUBJECT: Saudi Oil Policy After Yamani [redacted] 25X1

OGI/SRD/EMB [redacted] (5 December 86) 25X1

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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

5 December 1986

Saudi Oil Policy After Yamani

Summary

King Fahd's decisions to fire former Saudi Oil Minister Yamani and seek an increase in oil prices to $18 per barrel do not portend a major shift in Saudi oil policy, in our view. Nonetheless, we believe the Yamani's dismissal--and the loss of his knowledge of the oil industry and negotiating skills within OPEC--probably will make Riyadh's petroleum policies more unpredictable over at least the near term. While not abandoning its longer-term goal of a stable market for its oil, Riyadh is now focusing primarily on raising and stabilizing prices to generate more revenues. Over the next year, we believe the Saudi strategy will be dominated by efforts to achieve oil revenues of close to $30 billion--consistent with the King's goals of 5 million b/d of crude oil production and $18 per barrel. Saudi Arabia is already producing at about 5 million b/d and is encouraging OPEC to take steps necessary to raise prices from current levels of about $14 to $18 per barrel. [redacted] 25X1

Despite the King's efforts, we believe oil prices will remain volatile and average $10-14 per barrel over at least the next six months. Based on our forecast of market conditions, we believe that OPEC would need to cut output by at least one million b/d by early next year to raise prices to $18 per barrel. While there appears to be general agreement on the goal of higher prices, members are

This memorandum was prepared by [redacted] 25X1 [redacted] the Office of Global Issues, with a contribution from 25X1 [redacted] the Office of Near Eastern and South Asia, and [redacted] the Office of 25X1 Leadership Analysis. The information contained herein is updated through 17 November 1986. Questions and comments are welcome and can 25X1 be directed to [redacted] Chief, Strategic Resources Division, [redacted] 25X1

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unlikely to establish a workable production-allocation scheme at next week's ministerial session in Geneva. In our judgment, Riyadh will likely hold production steady as long as prices remain near current levels. There is a risk, however, that if prices erode Riyadh will increase production substantially in pursuit of higher revenues, causing another major price collapse. After another year or so of low oil prices, we believe that increased oil demand and the slowdown of non-OPEC production would make the King's goal of $18 per barrel oil prices achievable with OPEC production near current levels.

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Saudi Oil Policy After Yamani

Introduction

We believe former Saudi Oil Minister Yamani's dismissal stemmed primarily from a steadily deteriorating relationship with King Fahd which probably reached its nadir during the OPEC ministerial meeting in October [redacted] King Fahd 25X1 clearly was unhappy with Yamani's performance at the session and lost confidence in him to pursue vigorously the King's objectives. With Yamani's ouster, King Fahd has decided to assume more personal responsibility for Saudi oil policy. Fahd apparently wants both higher prices--near $18 per barrel--and higher Saudi output, which probably will be very difficult to achieve in the near term. [redacted] 25X1

Overall Policy Unchanged

Saudi officials have indicated publicly that Saudi longer-term oil policy remains unchanged, indicating Riyadh will continue to 25X1 produce near current levels of output and ensure a long-term market for its oil by making consuming nations more dependent on oil.

[redacted]

In our view, while long-term objectives remain intact, the Saudi short-term strategy now emphasizes the revenue objective by maximizing earnings at higher and stable prices. The shift in emphasis stems mainly from Fahd's increasing concern about chronic budget deficits and growing criticism by senior princes and technocrats about fiscal mismanagement. Now that prices have fallen from $28 per barrel to about $14 (figure 1), conditions that will improve the longer-term outlook have largely been set in motion. These conditions include higher oil demand and a slowdown in non-OPEC output. King Fahd probably believes that oil prices at $18 per barrel will ease the revenue problem and sustain this year's favorable oil market trends. 25X1 [redacted]

Revenues: Same Problem, New Approach

King Fahd is concerned that current oil prices will be insufficient to generate enough revenues for the upcoming 1986/87

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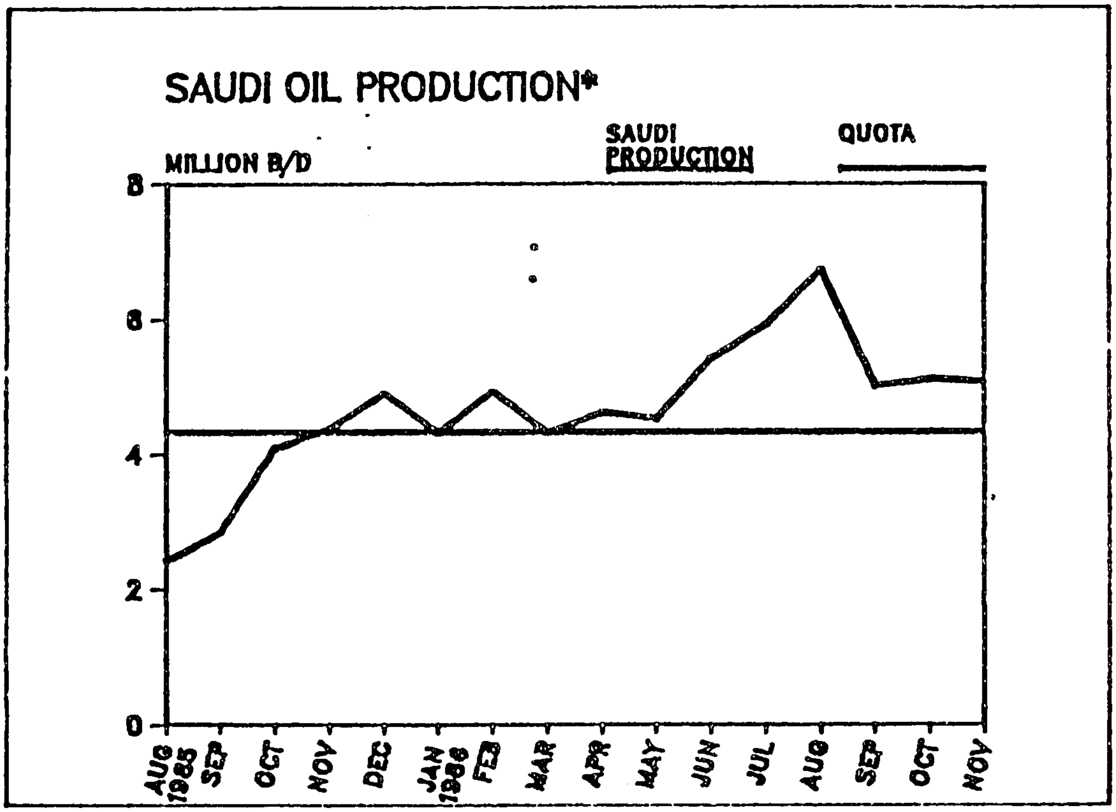
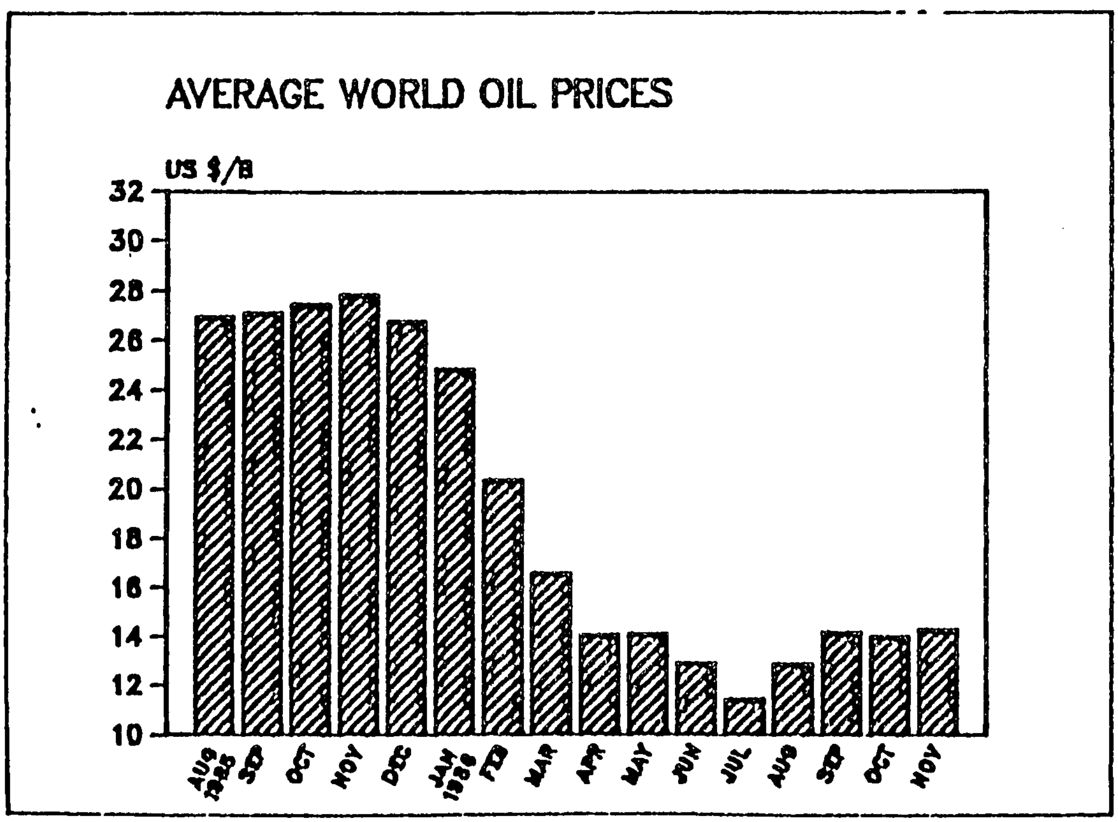
Figure 1

SAUDI OIL PRODUCTION AND AVERAGE WORLD OIL PRICES





*INCLUDES NEUTRAL ZONE PRODUCTION.

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Saudi budget and does not want to draw down financial reserves much further. We estimate that reserves are now about $80-85 billion, but not all of theses assets are liquid. 25X1
we believe Riyadh probably will announce government 25X1
expenditures of about $40 billion. Non-oil income is expected to provide some $10 billion. This implies that Riyadh believes it needs about $30 billion in oil revenues to balance the budget. 25X1

Over the next year, we believe Saudi oil strategy will be dominated by efforts to achieve oil revenues close to $30 billion. The King's production and price goals of 5 million b/d and $18 per 25X1
barrel would yield revenues close to this target (see figure 2). Since Riyadh is already producing near 5 million b/d, from the King's viewpoint all that is necessary is to raise prices from their current level of about $14 per barrel to achieve the revenue target.

Other combinations of oil prices and output that would earn Riyadh close to $30 billion are probably less desirable from Fahd's viewpoint. At current prices or lower, for example, the Saudis would have to produce more than 6 million b/d to generate the revenue target. Such production volumes would almost certainly trigger another price war, making it more difficult to achieve the revenue goal. If prices were to fall below $10 per barrel, the Saudis would have particular difficulty earning $30 billion in 1987 as the output necessary might exceed current productive capacity. 25X1

Riyadh at the OPEC Meeting

King Fahd's apparent strategy heading into the 11 December OPEC session in Geneva is to encourage the group to adopt his price objective of $18 per barrel. He may have already succeeded; OPEC's price committee recently announced it would recommend that target to the full ministerial session in Geneva. Now that the target appears to be a common objective, Riyadh is in a better position to ask other members of the group to make any production cuts necessary to support prices. We expect acting Saudi Oil Minster Nazir will try to pressure other members to accepting most of the burden of supporting higher prices through a 10 percent cut in overall OPEC output, according to Embassy reporting. 25X1

Despite some positive signs going into the meeting, reporting from member countries suggests the group's support for higher prices is superficial and that the Saudis will have difficulty garnering a strong OPEC commitment to support prices. Some OPEC officials are billing the December meeting as perhaps the cartel's most difficult session ever, and any Saudi inflexibility would make agreement even more elusive. The Saudis probably will not assume the role of swing

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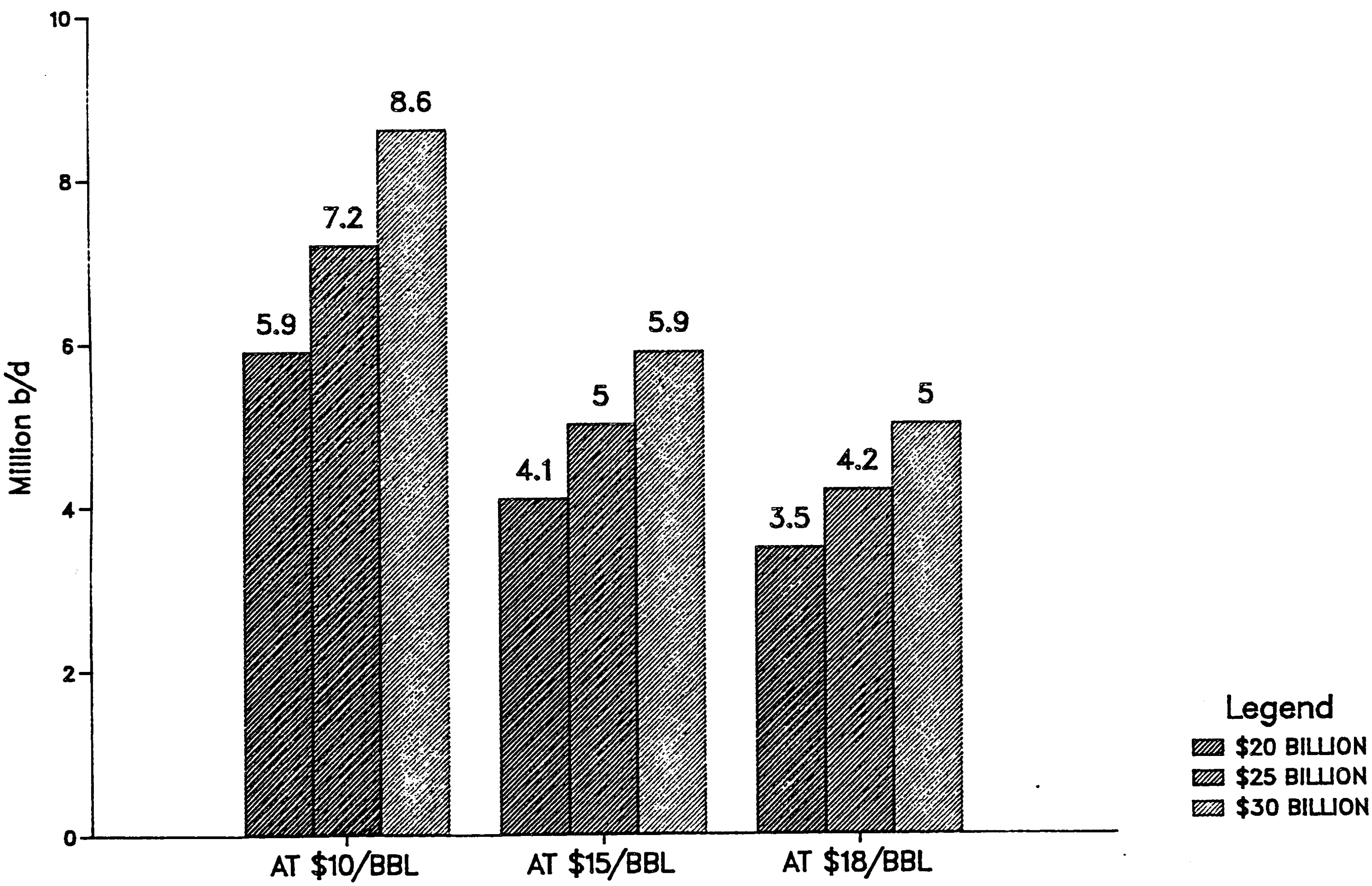
Figure 2

SAUDI CRUDE OIL PRODUCTION NECESSARY TO REACH SELECTED REVENUE TARGETS



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[redacted] 25X1

producer alone. If the group comes close to a realistic scheme to raise prices, however, Riyadh may be willing to lower output slightly if its relative share within the cartel remains near the current level of about 25 percent. This would be a difficult decision for Fahd, however, because such an effort could result in a reduction in oil revenues. [redacted] 25X1

<u>Can Fahd Succeed?</u>

In our judgment, based on our forecast of market conditions in 1987, OPEC will have a difficult time raising oil prices to $18 per barrel at least over the next six months. At current prices, we expect demand for OPEC oil next year as a whole to average near current OPEC production--including natural gas liquids--of about 19 million b/d. Low seasonal demand in the spring, however, will probably hold demand below 18 million b/d during the first half of 1987. Thus, if OPEC does not decrease output during this period, prices could fall considerably. Prospects of lower prices would probably lead to higher-than-anticipated stock draws, which would increase downward pressure on oil prices. Under these conditions, a replay of circumstances in 1986 could evolve, with prices temporarily falling rapidly to as low as $10 per barrel. [redacted] 25X1

In our judgment, to raise oil prices to $18 per barrel in the near term would require a decision by OPEC to hold down oil output. We believe the cartel needs to:

- **Cut output by at least 1 million b/d** from current levels early next year. This should boost prices during a season of high demand and create the expectation of higher prices for the rest of the year, thus discouraging a large stock draw. The group would also need to ensure strict compliance with the new guidelines to prevent price erosion.

- **Seasonally adjust output.** Further cuts in the spring would be needed to maintain the higher price.

- **Make these output decisions early** to avoid excessive speculation and market volatility.

- **Abandon netback or market-linked pricing arrangements**--where crude prices are allowed to swing with fluctuations in market conditions--if a fixed-pricing scheme is to be initiated. [redacted] 25X1 [redacted] 25X1

Oil stocks remain the wildcard in the near term market outlook. We estimate primary oil stocks onshore at the end of September stood

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at 4.3 billion barrels, about 200 million barrels above levels a year earlier. The unanticipated huge stock build-up earlier this year--due primarily to overproduction by OPEC--is ready to be tapped at the first sign of price weakness. Expectations of at least stable if not rising prices are needed to discourage a drawdown of inventories at greater-than-normal levels in the near term. [redacted] 25X1

<u>Little Help From Other OPEC Countries</u>. Despite endorsement of higher prices, other OPEC countries do not appear prepared to take the steps necessary to raise and hold prices near $18 per barrel. [redacted] 25X1

Many OPEC officials have indicated that members will try to avoid discussions on production quotas for another six months and will merely extend the current system. Moreover, Arab producers continue to produce above their quotas. This will begin to increase oversupply pressures now that Iran has made repairs to damaged export facilities, enabling it to increase production by over a million b/d above August-October levels of about 1.2-1.4 million b/d. [redacted] 25X1

<u>Implications</u>

<u>For Prices</u>. Despite the King's desire for price stability, we believe the market over the next six months or so will return to the volatility experienced in the first half of this year, with prices averaging $10-14 per barrel. How far prices fall will depend on what the Saudis do after the OPEC meeting (see Annex 1 "Key Indicators of Saudi Oil Strategy"). Because OPEC is unlikely to take the steps necessary to hold down output, probably the best revenue option available to Riyadh is to continue producing at least 5 million b/d and allow prices to erode somewhat during the next several months. Although this combination would temporarily yield oil export revenues at an annual rate of less than $25 billion, the alternative--substantially boosting output--would push prices well below $10 per barrel, and make matching even this level of earnings very difficult. Nevertheless, the King may decide to pursue this latter route to teach other OPEC members that lowering output to support higher prices is less painful financially than a price war. [redacted] 25X1

In the less likely case where the Saudis decide to compromise at the OPEC meeting and OPEC countries agree to lower output by about one million b/d, prices could rise to the $15-18 range in the near term. After midyear, if OPEC kept output near 18 million b/d, prices would probably remain above $15 per barrel. [redacted] 25X1

[redacted] 25X1

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We believe the King's objectives are more easily attainable after next year. Market forces will continue to work in OPEC's favor. Increased demand and flat or declining non-OPEC output will boost demand for OPEC oil. If the cartel keeps output near current levels, we believe prices could rise to near $18 per barrel by early 1988. 25X1 25X1

For Saudi-Iranian Oil Policy Conflicts. While we believe considerations about Iran have played a relatively minor role in Saudi oil policy in the past, the role of the Iranians in the future is less certain. Fahd has been able to avoid a confrontation with Tehran so far, but his goal to boost revenues might lead him to ignore the objectives of other members--including Iran. If the King judges the best way to increase earnings is by raising output, for example, then prices would fall, raising the risk of a major confrontation with Tehran. On the other hand, the prospect for such a confrontation could make Fahd more cautious on oil matters. A major oil price collapse and heightened tensions with Tehran probably would lead to increased criticism of Fahd within the royal family, particularly if oil revenues remained about the same or fell. 25X1

For the near term, Fahd probably will do little to dispel Iran's perception that Fahd's support of higher prices and Yamani's dismissal were conciliatory gestures to Iran. Any alliance between the two at the meeting, however, probably will hinge largely on which position Riyadh takes on the issue of Iraqi production. Nevertheless, Riyadh probably will oppose an expected Iranian move to include Iraq in any new allocation scheme. Any OPEC production accord will be complicated by the substantial increase in Baghdad's export capacity expected in mid-1987. Saudi unwillingness to address this issue could indicate Riyadh is not fully committed to sustaining higher prices. 25X1

For the United States. Saudi longer-term oil market objectives continue to have implications for US energy security in the next decade. If conditions conducive to market control--especially strong growth in oil demand, little growth in non-OPEC supplies and eroding surplus capacity--are sustained, a group of key oil exporters in the Persian Gulf area will regain important influence over the oil market in the 1990s. Moreover, because surplus capacity will increasingly become concentrated in the Persian Gulf area, less supplies will be available elsewhere to help offset an interruption of supply from this region. Even if the United States maintains a relatively low level of imports and a diversity of suppliers, the high import dependence of other major consumers will make the US market susceptible to the price impact and other effects of a disruption. 25X1

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Annex 1

Key Indicators of Saudi Oil Strategy

If King Fahd is serious about pursuing a price support strategy in coming months we expect the Saudis to begin taking more concrete actions which could be detected both in OPEC forums and in the marketplace. So far we have seen no firm indications that Riyadh is ready to make such a commitment. We have identified below actions that would provide advanced notice whether the Saudis are indeed willing to support prices or whether they see fixed prices as an eventual goal, and will sustain market share as the best way to maximize revenues. 25X1

<u>Price Support Approach</u>

- Phase out netback contracts and encourage the same from other members.
- Reduce oil production toward quota of 4.35 million b/d.
- Increase bilateral contacts with Persian Gulf producers, including Iran.
- Maintain pragmatic, flexible position at OPEC meetings.
- Make legitimate attempt to agree on fluctuating OPEC ceiling, individual quotas, crude oil price differentials.
- Support Iranian insistence that Iraq be included in OPEC quota system.

<u>Market Share Approach</u>

- Continuation of netback contracts, or renewal of discounts to maintain export volume.
- Sustain output at or above current levels of 5 million b/d.
- Remain inflexible, using a take-it-or-leave-it attitude at December OPEC session.
- Leave Geneva with weak or unsound agreement, postponing discussions on difficult issues.
- Increase security measures at key oil installations.
- Maintain technical ability to raise output within a wide range.

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Candidates for Saudi Oil Minster

Hisham Nazir
Acting Petroleum Minister

Nazir, 54, is a senior technocrat with proven administrative skills and familiarity with petroleum issues. A protege of King Fahd, who made him Minister of Planning in 1975, he was the architect of the Kingdom's 5-year economic development plans and is currently a member of the Supreme Petroleum Council. He served as Deputy Minister of Petroleum from 1962 until being named to head the Central Planning Organization in 1968. He [redacted] had been mentioned as a possible replacement for Yamani as early as 1982. It is unlikely that Nazir will be as influential as Yamani on oil matters and likely will defer to the King on policy issues. Barring a complete failure of oil policy, we believe that Nazir will retain his position in the medium term, given Fahd's tendency to defer decisions on sensitive issues. [redacted] 25X1

Bandar bin Sultan
Ambassador to the United States

A bright star among younger generation royal family members, Bandar bin Sultan is viewed by some Saudi observers as a leading contender to become the permanent replacement for Yamani. He is capable, dynamic, and extremely ambitious prince whose career horizons lie beyond his role as ambassador. A former air force officer with an advanced degree from Johns Hopkins, Bandar, 37, possesses proved diplomatic skills honed in Washington as the Kingdom's chief lobbyist for the purchase of US arms and as a special envoy of the King's on sensitive diplomatic missions. A son of Defense Minister Sultan, Bandar enjoys a close relationship with the King, for whom he has become his major adviser on US-Saudi relations. [redacted] 25X1

In our view, Bandar has a good chance of being selected as petroleum minister should Fahd look to the royal family to fill the post on a permanent basis. His talent, connections, and supreme self-confidence compensate for his lack of experience in international petroleum affairs. If selected, his role would likely be one of negotiator and spokesman, and he could be expected to fully support Fahd's policies. He appears to have been one of Yamani's sharpest critics and may have helped persuade the King to remove him. [redacted]

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Sa'ud al-Faysal
Minister of Foreign Affairs

Sa'ud, about 46, entered the Ministry of Petroleum in 1966 and served as Deputy Minister from 1971 until becoming Foreign Minister in 1975. Sa'ud has long been rumored as the leading candidate to replace Yamani, and is considered the most knowledgeable senior official in the Kingdom outside oil matters. Through his diplomatic contacts he is reportedly already aquainted with many OPEC personalities. The Embassy in Riyadh recently noted that Sa'ud has maintained his interest in oil matters, although he is not thought to currently have any impact on policy. [redacted] 25X1

Fahd, however, neither particularly likes nor trusts Sa'ud, a son of former King Faysal, and has allowed him little independence in the conduct of foreign policy. [redacted]

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'Abd al-Hadi Tahir
Governor, General Organization of Petroleum and Mineral (Petromin)

If expertise were the only criterion, Tahir, 55, would be the best choice as the permanent replacement for Yamani. He has been the chief executive officer of Petromin since 1962 and has been referred to as the only official with the talent and experience to compare with Yamani. According to Embassy reporting, Yamani frequently benefited from Tahir's knowledge of domestic energy issues. He and Yamani have enjoyed close personal ties and were often allied in bureaucratic turf battles. In addition, there are some indications that suggest Tahir has played a role in marketing special allotments of crude oil on behalf of royal family members. His discretion in handling those deals could improve his acceptability as Petroleum Minister to senior princes. [redacted] 25X1

[redacted] 25X1